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## NATURE, OBJECTIVE AND SCOPE OF AUDIT

## 1 INTRODUCTION

What do we mean by auditing? What is its nature and scope? What it includes and what it does not? What are its limitations? We shall try to find out answers to these questions in succeeding paras.

## 2 ORIGIN OF AUDITING

Before we get to understand meaning and nature of auditing, let's travel back in time to know about origin of auditing. Auditing has existed even in ancient times in many societies of world including India. The reference to auditing is found in Kautilya's *Arthshastra* even in 4<sup>th</sup> century BC. It talks about fixed accounting year, a process for closure of accounts and audit for the same. Concepts of periodical checking and verification existed even in those times.

The word "audit" originates from Latin word "*audire*" meaning "to hear". In medieval times, auditors used to hear the accounts read out to them to check that employees were not careless and negligent. Industrial revolution in Europe led to astronomical expansion in volume of trade and consequently demand of auditors.

Coming to more recent history, the first Auditor General of India was appointed in British India in 1860 having both accounting and auditing functions. Later on, office of Auditor General was given statutory recognition. Presently, Comptroller and Auditor General of India is an independent constitutional authority responsible for auditing government receipts and expenditures.

The Institute of Chartered Accountants of India was established as a statutory body under an Act of Parliament in 1949 for regulating the profession of Chartered Accountancy in the country.

## 3 MEANING AND NATURE OF AUDITING

"An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon".

**Auditing provides assurance:** Its basic nature *lies* in providing assurance to users - providing confidence to users of financial statements. Such an assurance lends credibility to financial statements. Audited financial statements provide confidence to users that financial information reflected in financial statements can be relied upon.

#### 4. INTERDISCIPLINARY NATURE OF AUDITING- RELATIONSHIP WITH DIVERSE SUBJECTS

Auditing is interdisciplinary in nature. It draws from diverse subjects including accountancy, law, behavioural science, statistics, economics and financial management and makes use of these subjects. Since audit of financial statements is concerned with financial information, **a sound knowledge of accounting principles** is a fundamental requirement for an auditor of financial statements to conduct audit and express an opinion. Similarly, **good knowledge of business laws and various taxation laws** helps auditor to understand financial statements in a better way in accordance with applicable laws.

During course of audit, auditor has to **interact with lot of persons** for seeking information and making inquiries. This can be done only if one has **knowledge of human behaviour**. Auditors use **statistical methods to draw samples** in a scientific manner. It is not possible for an auditor to check each and every transaction. So, use of **statistical methods** to draw samples for conducting audit is made.

Knowledge of subject like **economics** helps auditor to be familiar with **overall economic environment** in which specific business is operating. **Financial management** deals with issues such as funds flow, working capital management, ratio analysis etc. and an auditor is expected to be **knowledgeable about these for applying some of audit procedures** and carrying out audit effectively. Besides, knowledge of financial markets comprised in study of financial management is expected from a professional auditor.

1. Auditing and Accounting
2. Auditing and Law
3. Auditing and Economics
4. Auditing and Behavioural Science
5. Auditing and Statistics & Mathematics
6. Auditing and Data Processing

7. Auditing and Financial Management

8. Auditing and Production

## 5 OBJECTIVES OF AUDIT

In conducting audit of financial statements, objectives of auditor in accordance with SA-200 “Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing” are:-

- (a) To obtain **reasonable assurance** about whether the **financial statements** as a **whole are free from material misstatement**, whether due to **fraud or error**, thereby enabling the auditor to **express an opinion** on whether the financial statements are prepared, in all material respects, in accordance with an **applicable financial reporting framework**; and
- (b) To **report on the financial statements**, and **communicate** as required by **the SAs**, in accordance with the auditor’s findings.

An analysis of above brings out following points clearly: -

- (1) Auditor’s objective is to obtain a reasonable assurance whether financial statements as a whole are free from material misstatement whether due to fraud or error. Reasonable assurance is to be distinguished from absolute assurance. **Absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements.** However, **reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.**
- (2) Misstatements in financial statements can occur due to fraud or error or both. The auditor seeks to obtain reasonable assurance whether financial statements *as a whole* are free from material misstatements caused by fraud or error. **He has to see effect of misstatements on financial statements as a whole, in totality.**
- (3) **Obtaining reasonable assurance** that financial statements as a whole are free from material misstatements enables the auditor to express an opinion.
- (4) The **opinion is reported and communicated** in accordance with audit findings through a written report as required by Standards on Auditing.

## 6 SCOPE OF AUDIT-WHAT IT INCLUDES

Scope refers to *range or reach* of something. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.

The following points are included in scope of audit of financial statements: -

(1) **Coverage of all aspects of entity**

Audit of financial statements should be organized adequately to **cover all aspects** of the entity relevant to the financial statements being audited.

(2) **Reliability and sufficiency of financial information**

The auditor should be reasonably satisfied that information contained in underlying accounting records and other source data (like bills, vouchers, documents etc.) is **reliable and sufficient basis for preparation of financial statements**.

The auditor makes a judgment of reliability and sufficiency of financial information by making a **study and assessment of accounting systems** and **internal controls** and **by carrying out appropriate tests, enquiries and procedures**.

(3) **Proper disclosure of financial information**

The auditor should also decide whether relevant information is **properly disclosed** in the financial statements. He should also keep in mind applicable **statutory requirements** in this regard.

It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the **judgments made by management** in preparation of financial statements.

The auditor evaluates **selection and consistent application of accounting policies** by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

- ❖ Understand that financial statements of an entity are prepared on historical financial information basis. **"Historical financial information"** means information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

6.1 **Scope of audit-What it does not include**

Auditor is not expected to **perform duties which fall outside domain of his competence**. For example, physical condition of certain assets like that of sophisticated machinery cannot be determined by him. Similarly, it is not expected from an auditor to determine suitability and life of civil structures like buildings. These require different skillsets which may be performed by qualified engineers in their respective fields.

An auditor is **not an expert in authentication of documents**. The genuineness of documents cannot be authenticated by him because he is not an expert in this field.

An audit is not an official *investigation* into alleged wrong doing.

**Audit is distinct from investigation**. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.

The scope of audit is general & broad whereas scope of investigation is specific & narrow.

#### An Overview of Scope of Audit

Check box	Scope of audit of financial statements
✓	Coverage of all aspects of entity relevant to the financial statements being audited.
✓	Reliability and Sufficiency of financial information
✓	Proper disclosure of financial information
✓	Expression of an opinion on financial statements
X	Responsibility of preparation and presentation of financial statements
X	Duties outside scope of competence of auditor
X	Expertise in authentication of documents
X	Investigation

## 7. INHERENT LIMITATIONS OF AUDIT

The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors: -

### (1) Nature of financial reporting

Preparation of financial statements involves making **many judgments by management**. These judgments may involve **subjective decisions or a degree of uncertainty**. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such **controls may not have operated to produce reliable financial information due to their own limitations**.

**(2) Nature of Audit procedures**

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are **practical and legal limitations** on ability of auditor to obtain audit evidence. For example, an **auditor does not test all transactions and balances**. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Management may not provide complete information as requested by auditor. **There is no way by which auditor can force management to provide complete information as may be requested by auditor**. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

The management **may consist of dishonest and unscrupulous people** and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.

**(3) Not in nature of investigation**

As already discussed, audit is not an official investigation.

**(4) Timeliness of financial reporting and decrease in relevance of information over time**

The relevance of information decreases over time & auditor cannot verify each and every matter. Therefore, a balance has to be struck between **reliability of information and cost of obtaining it**.

Consider, for example, an auditor who is conducting audit of a company since last two years. During these two years, he has sought detailed information from management of company regarding various matters. During his third- year stint, he chooses to rely upon some information obtained as part of audit procedures of second year. However, it could be possible that something new has happened and that information is not relevant. So, the information being relied upon by auditor is not timely and may have lost its reliability.

**(5) Future events**

Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future

due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.

Therefore, it is in view of above factors, that an auditor cannot provide a guarantee that financial statements are free from material misstatements due to frauds or errors.

## 8. WHAT IS AN ENGAGEMENT?

**Engagement means an arrangement to do something.** In the context of auditing, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services. **It takes the shape of engagement letter.**

### 8.1 External audit engagements

**The purpose of external audit engagements is to enhance the degree of confidence of intended users of financial statements.** Such engagements are also reasonable assurance engagements.

## 9. BENEFITS OF AUDIT-WHY AUDIT IS NEEDED?

- ◆ Audited accounts provide **high quality information**. It gives confidence to users
- ◆ In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As shareholders are owners of the company, they need an **independent mechanism** so that financial information is qualitative and reliable.
- ◆ An audit acts as a **moral check on employees** from committing frauds for the fear of being discovered by audit.
- ◆ Audited financial statements are **helpful to government authorities** for determining tax liabilities.
- ◆ Audited financial statements can be **relied upon by lenders, bankers** for making their credit decisions *i.e.* whether to lend or not to lend to a particular entity.
- ◆ An audit may also **detect fraud or error or both**.
- ◆ An audit **reviews existence and operations of various controls** operating in any entity. Hence, it is useful at pointing out deficiencies.

## 10. AUDIT- MANDATORY OR VOLUNTARY?

It is not necessary that audit is always legally mandatory. There are entities like companies

who are compulsorily required to get their accounts audited under law. Even non-corporate entities may be compulsorily requiring audit of their accounts under tax laws. For example, in India, every person is required to get accounts audited if turnover crosses certain threshold limit under income tax law.

It is also possible that some entities like schools may be required to get their accounts audited for the purpose of obtaining grant or assistance from the Government.

Audit is not always mandatory. Many entities may get their accounts audited voluntarily because of benefits from the process of audit. Many such concerns have their internal rules requiring audit due to advantages flowing from an audit.

#### 11. WHO APPOINTS AN AUDITOR?

Generally, an auditor is appointed by owners or in some cases by constitutional or government authorities in accordance with applicable laws and regulations. For example, in case of companies, auditor is appointed by members (shareholders) in Annual General Meeting (AGM). Shareholders are owners of a company and auditor is appointed by them in AGM.

However, in case of government companies in India, auditor is appointed by Comptroller and Auditor General of India (CAG), an independent constitutional authority.

Take case of a firm who engages an auditor to audit its accounts. In such a case, auditor is appointed by partners of firm.

There may be a situation in which auditor may be appointed by a government authority in accordance with some law or regulation. For example, an auditor may be appointed under tax laws by a government authority.

#### 12. TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

The outcome of an audit is written audit report in which auditor expresses an opinion. The report is submitted to person making the appointment.

#### 13. MEANING OF ASSURANCE ENGAGEMENT

“Assurance engagement” means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

### 13.1 Elements of an Assurance Engagement

Following elements comprise an assurance engagement: -

#### 1. A three-party relationship involving a practitioner, a responsible party, & intended users

A **practitioner** is a person who provides the assurance. The term practitioner is broader than auditor.

A **responsible party** is the party responsible for preparation of subject matter.

**Intended users** are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.

#### 2. An appropriate subject matter

It refers to the information to be examined by the practitioner.

#### 3. Suitable criteria

These refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.

#### 4. Sufficient appropriate evidence

The practitioner performs an assurance engagement to obtain sufficient appropriate evidence. It is on the basis of evidence that conclusions are arrived and an opinion is formed by auditor.

#### 5. A written assurance report in appropriate form

A written report is provided containing conclusion that conveys the assurance about the subject matter. A written assurance report is the outcome of an assurance engagement.

### 13.2 Meaning of Review; Audit Vs. Review

We have learnt that audit is a reasonable assurance engagement. It provides reasonable assurance. However, **review is a limited assurance engagement**. It provides lower level of assurance than audit. Further, **review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up**.

However, both “audit” and “review” are related to financial statements prepared on the basis of historical financial information.

### 13.3 Types of Assurance Engagements- Reasonable assurance engagement vs. Limited assurance engagement

Reasonable assurance engagement	Limited assurance engagement
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	Example of limited assurance engagement is review engagement.

**“Prospective financial information” means financial information based on assumptions about events that may occur in the future and possible actions by an entity.**

It can be in the form of a forecast or projection or combination of both.

It is to be noted that in such type of assurance engagements, examination is not of historical financial information.

Here, it is important to note the difference between “Historical financial information” and “Prospective financial information.” The former relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The latter relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.

Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.

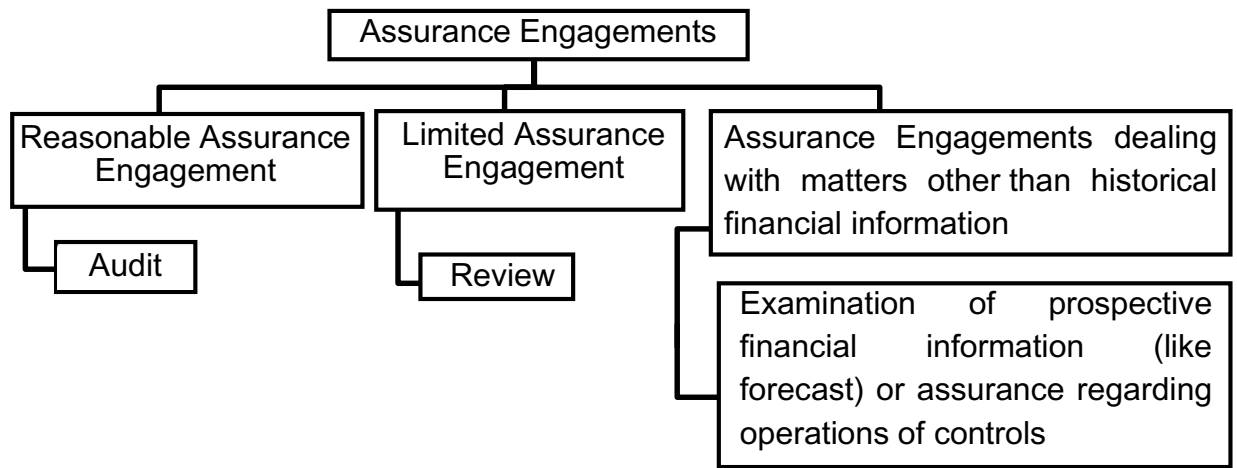
In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that **management's assumptions on which the prospective financial information is based are not unreasonable**, the prospective financial information is properly prepared on the basis of the assumptions and it is properly presented and all material assumptions are adequately disclosed.

Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection.

Hence, such type of assurance engagement provides only a “moderate” level of assurance.

Examples of assurance engagements

Checkbox	Example of engagement assurance	Type of assurance engagement
✓	Audit of financial statements	Reasonable assurance engagement
✓	Review of financial statements	Limited assurance engagement
✓	Examination of Prospective financial information	Provides assurance regarding reasonability of assumptions forming basis of projections & related matters
✓	Report on controls operating at an organization	Provides assurance regarding design and operation of controls



14. QUALITIES OF AUDITOR

An auditor is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent.

Tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability are some of qualities which an auditor should have. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence.

The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

**15. ENGAGEMENT AND QUALITY CONTROL STANDARDS: AN OVERVIEW**

The following Standards issued under authority of ICAI Council are collectively known as Engagement Standards: -

1. **Standards on auditing (SAs)** which apply in audit of historical financial information.
2. **Standards on review engagements (SREs)** which apply in review of historical financial information.
3. **Standards on Assurance engagements (SAEs)** which apply in assurance engagements other than audits and review of historical financial information.
4. **Standards on Related Services (SRSs)** which apply in agreed upon procedures to information, compilation engagements and other related service engagements.

**15.1 Standards on Auditing**

Standards on Auditing apply in the context of an audit of financial statements by an independent auditor. It is important to remember that Standards on Auditing apply in audit of historical information. These establish high quality benchmarks and are followed by auditors in conducting audit of financial statements.

**Some examples of Standards on Auditing are: -**

- ◆ **SA 200** Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing
- ◆ **SA 230** Audit Documentation
- ◆ **SA 315** Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
- ◆ **SA 500** Audit Evidence
- ◆ **Revised SA 700** Forming an Opinion and Reporting on Financial Statements

**15.2 Standards on Review Engagements**

Standards on review engagements apply in the context of review of financial statements.

**Examples of Standards on Review engagements are:**

- ◆ **SRE 2400 (Revised)** Engagements to Review Historical Financial Statements
- ◆ **SRE 2410** Review of Interim Financial Information Performed by the Independent Auditor of the Entity

**It is to be noted that both Standards on auditing and Standards on review engagements apply to engagements involving historical financial information.**

**15.3 Standards on Assurance Engagements**

There is another set of standards which apply in assurance engagements dealing with subject matters other than historical financial information. Such assurance engagements do not include “audit” or “review” of historical financial information. These standards are known as Standards on Assurance Engagements.

Examples of Standards on Assurance Engagements are:

- ◆ **SAE 3400** The Examination of Prospective Financial Information
- ◆ **SAE 3420** Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

**15.4 Standards on Related Services**

Lastly, there are standards on related services. These standards apply in engagements to **perform agreed-upon procedures** regarding financial information.

For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales & profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.

An engagement in which practitioner may be called upon to **assist management with the preparation and presentation of historical financial information** without obtaining assurance on that information. Such type of compilation engagements fall in the category of related services and practitioner issues a report clearly stating that it is not an assurance engagement and no opinion is being expressed.

These types of services are called related services and standards have been issued to deal with practitioner’s responsibilities in this regard.

**Examples of Standards on related services are:**

- ◆ **SRS 4400** Engagements to perform agreed-upon procedures regarding financial information
- ◆ **SRS 4410 (Revised)** Compilation engagements

**Engagement Standards issued under the authority of Council of ICAI deal with responsibilities of auditor/practitioner.**

**15.5 Standards on Quality Control**

Standards on Quality Control (SQC) have been issued to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements.

Further, it is also to be remembered that Standards on Quality Control (SQC) are to be applied for all services covered by Engagement Standards.

**15.6 Why are Standards needed?**

- Standards ensure carrying out of audit against **established benchmarks** at par with global practices.
- Standards **improve quality of financial reporting** thereby helping users to make diligent decisions.
- Standards **promote uniformity** as audit of financial statements is carried out following these Standards.
- Standards **equip professional accountants** with professional **knowledge and skill**.
- Standards ensure **audit quality**.

**15.7 Duties in relation to Engagement and Quality Control Standards**

It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them. Ordinarily, these are to be followed by professional accountants. **However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, he is required to document how alternative procedures performed achieve the purpose of required procedure.** Also, reason for departure has also to be documented unless it is clear. Further, his report should draw attention to such departures. It is also to be noted that a mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards.